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TAGS: EFIN ECON PREL CH
SUBJECT: CHINA: RISKS OF RAPID CREDIT GROWTH INCLUDE NPLS,
INFLATION

REF: A. BEIJING 0354
¶B. 08 BEIJING 4481

Classified By: Economic Minister Counselor Robert Luke; Reasons 1.4 (b and d)

¶1. (C) Summary. Monetary policy will play a necessary but less important and less visible role than fiscal policy in addressing China's cyclical downturn, according to People's Bank of China (PBOC) Monetary Policy Director General Zhang Xiaohui. With the CPI at one percent in January, expectations are growing for further interest rate cuts, but room for such actions is limited. PBOC is concerned that recent large infusions of liquidity may risk "sowing the seeds" for future inflation and it is aware of the need to have a sound exit strategy from the current loose monetary policy, for when the economy recovers. Chinese banks have been willing to expand lending despite excess productive capacity and the deteriorating outlook for several reasons, including commercial pressure to deploy available funds, linkage of much of the new credit to the central government's fiscal stimulus package, relaxation of the non-performing loan (NPL) policy and the fact that most banks are still state-owned or controlled and thus must implement the government's policy to expand lending. Although the Chinese Government has not issued specific lending instructions to the banks, senior bank managers are aware of their "policy responsibilities." Zhang does not expect any drastic changes in the USD-RMB exchange rate. End Summary.

Monetary Policy: Less Visible Role

¶2. (C) Monetary Policy Department DG Zhang Xiaohui discussed China's monetary policy and other financial issues with Financial Minister Counselor and Econoff on February 12. She said that in response to China's cyclical downturn, monetary policy will play a less important and less visible - but still necessary - role compared to fiscal policy. Cuts in lending rates and lower required reserve ratios have led to "phenomenal" lending growth: in November 2008, lending increased RMB 400 billion (USD 58.5 billion); in December, RMB 700 billion (USD 102 billion); and in January 2009, RMB 1.6 trillion (USD 234 billion). The PBOC is examining the latest data closely, as Zhang said it is not clear if the composition of new loans is fully consistent with the government's macroeconomic policy objectives.

Interest Rates: Little Room for Action

¶3. (C) With the CPI at one percent in January, Zhang said expectations are growing for further interest rate cuts, but room for such actions is limited. Interest rates on interbank loans and discounted bills already have fallen considerably, to very low levels. Lowering interest rates

further also risks inducing imprudent lending. Since the large Chinese banks were transformed into commercial banks, Zhang said they have not been tested by a downward economic cycle, and they lack experience on how to manage credit risks prudently during a recession. Lastly, further cuts in interest rates increases the risk of future overheating in the real economy. Even without further interest rate cuts, liquidity already is abundant and consumer confidence is ample (unlike the U.S.).

Inflation and Deflation Risks

¶4. (C) With the large infusions of liquidity, the PBOC is concerned China may risk "sowing the seeds" for future inflation, so the central bank needs to remain vigilant to the need for a sound exit strategy from the current loose monetary policy, when the economy recovers. Even though the probability of deflation has increased, this is not necessarily reason to ease monetary policy further. According to Zhang, deflation due to different factors requires different solutions. For example, it is not clear that the PBOC should respond to deflation resulting from lower input costs (e.g., commodities) -- which lead to an increase in real incomes -- by easing monetary policy. Moreover, by distorting price signals, the cost of aggressive monetary easing in response to deflation may prove higher than the cost of simply waiting for the deflationary impact of lower input prices to pass through the economy. On the other hand, Zhang noted that the current deflation in some asset markets in China, such as real estate, is because consumers believe prices will fall further, so they refuse to buy.

Promoting Policy Objectives vs. Commercial Prudence
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¶5. (C) Asked why banks have been so willing to expand lending despite excess productive capacity and the deteriorating outlook, Zhang said the U.S. and Chinese systems remain quite different, even after significant improvements in Chinese bank corporate governance. She listed four reasons why banks are so willing to lend: First, most Chinese banks are still primarily state-owned or state-controlled, including the joint-stock banks. As such, they have responsibilities to promote economic policy objectives even when it is not in their narrow commercial interest. Second, given funding costs, commercial banks are under commercial pressure to deploy available funds, which have increased due to the loosening of monetary policy. Similarly, due to the bank reforms of recent years, the banks have been able to earn enormous profits from mandated intermediation spreads, and their shareholders are pressuring them to continue this profitability through high lending growth rates. Third, a large part of the increase in credit is for projects linked to the central government's fiscal stimulus package, which enjoy implicit government support and lower credit risk. Fourth, the China Banking Regulatory Commission (CBRC) has relaxed its non-performing loan (NPL) policy. The former policy of "dual cuts in NPLs" (i.e., reducing NPL ratios as well as the absolute amounts of NPLs) has been replaced by "dual control," whereby commercial banks have more freedom and now only need to lower their NPL ratios, not the absolute amounts. This, said Zhang, constitutes a potential big increase in systemic risk.

Banks: No Pain, No Gain

¶6. (C) Asked whether specific loans that would not have been approved in the past now are being extended, Zhang observed that senior management appointments at the commercial banks are vetted by the Communist Party and have policy responsibilities. She stressed, however, that the Government has not issued any specific instructions to the banks to increase lending, including to specific firms or sectors. When the economy is not doing well (i.e., now), the banks can

"make some sacrifices" (with loans that they otherwise would not grant); when the economy recovers, so can the banks.

M2 Target

¶7. (C) Zhang stressed that the PBOC's 2009 M2 objective of 17 percent growth is more of an "aspiration" than a precise target. She said the PBOC's "formula" for setting the M2 growth target is, roughly, nominal GDP growth plus 3-5 percentage points. Since 2002, in addition to increases in net domestic credit, the increasing foreign assets resulting from large balance of payments surpluses has provided two channels for increasing the money supply. This year, however, the contribution from increase in net foreign assets will be reduced due to a smaller balance of payments surplus, so increases in net domestic credit will be more important.

Exchange Rate Stability

¶8. (C) Zhang said that with China's current large balance of payments surplus, there is room for further RMB appreciation. On the other hand, given the global crisis, heightened uncertainty and economic restructuring, China still remains "quite dependent" on exports for relatively rapid growth; from this perspective, depreciation also is a good choice. Furthermore, Zhang said many Chinese officials remain worried about a possible "second wave of shocks" from the U.S. that may cause the crisis to deepen further. In conclusion, she thinks there will be no change in the general direction of China's exchange rate reform, and for now avoidance of any drastic changes in the exchange rate is a sound option for both China and the U.S. (refs a, b).

Reaction to Paulson and Geithner Comments

¶9. (C) Regarding recent media reports of comments by Treasury Secretary Geithner and former Secretary Paulson on exchange rates and global imbalances, Zhang observed that "this is not a big issue for me." She added, however, that because the Chinese public often exerts pressure on the Chinese Government, officials needed to know the real story.

Comment

¶10. (C) The extent of the increase in credit in November and December appears to have caught PBOC officials by surprise. Concerned about continued weak corporate governance of Chinese banks, which our PBOC interlocutor readily and clearly admitted remain subject to influence by both the Chinese Government and the Communist Party, officials now appear concerned about a future accumulation of non-performing loans. As such, despite the likelihood of deflation, the PBOC appears intent on resisting public pressure to ease monetary conditions, through either lower interest rates or a depreciated exchange rate.

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